Sarbanes Oxley: Is there a quantifiable difference ?

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Introduction

At the beginning of the millennium, amidst national attention Waste Management, Enron, and WorldCom unleashed unforeseen multibillion dollar losses. Waste management adjusted their financial statements to meet management's expectations, to do this they incorrectly reported salvage value on its depreciable assets, as well as incorrectly record expense to name a few of their crimes. This resulted in them falsely overstating earning by 1.7 billion dollars (Eichenwald, 2002). Enron hid massive debts off their balance sheet therefore overstating their profits on their financial statements. This resulted in a 74 billion dollars of pension funds, shareholder funds, and thousands of jobs (Farrell, 2015). WorldCom claimed 3.8 billion of operating expenses as capital investments (Tran, 2002). Allowing them to improperly spread operational cost across several years which increased their profits. These are some of the world's most scintillating accounting events that caused major reform to the field of accounting for the United States. These events all occurred under the external accounting firm Arthur Anderson, which lead the firm to closed due to the events named above. Enlight of the various scandals at the turn of the century the Sarbanes Oxley Act of 2002 (SOX) created standards for auditors to protect public interest within the organization. They created the Public Company Accounting Oversight Board (PCAOB) to oversee the audits of public companies. They also issue auditing standards, inspect accounting firms and enforce compliance. In the field of auditing this translated to increased accountability, stricter guidelines for separation of duty, and due diligence when testing the strength of internal controls.

Question

How do we test the ramifications of the Sarbanes Oxley Act?

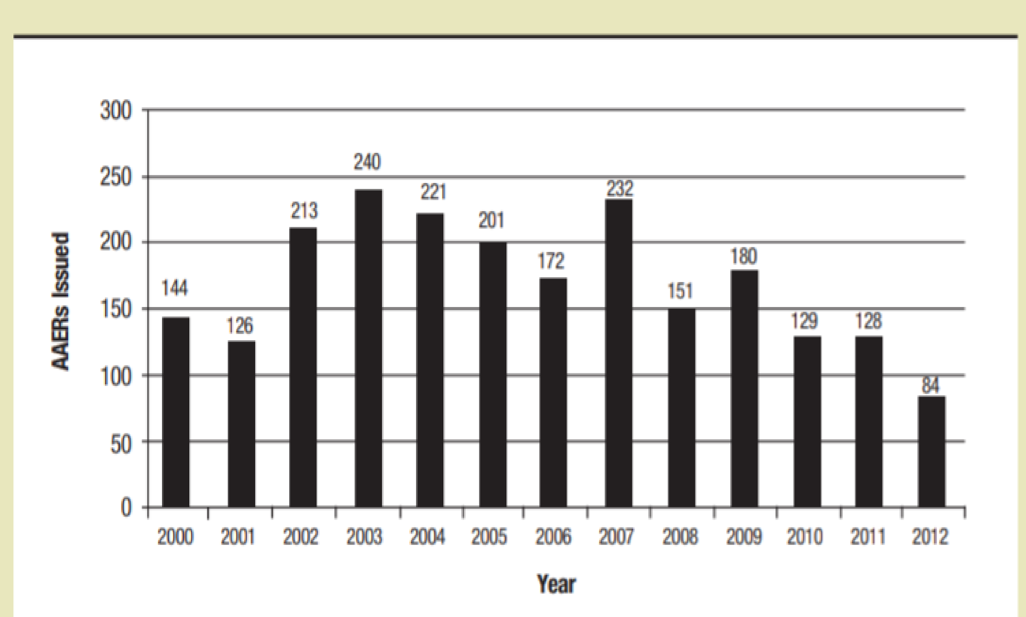
We would like to evaluate pre and post the implementation of the Sarbanes Oxley Act of 2002 the amount of fraud that occurred, and the quality of recent audits.

Methodology & Results

Quantification of Fraud

The Security and Exchange Commission (SEC) uses Accounting and auditing enforcement releases (AAER) in fraud cases that involve an accountant; they are often uses in accounting research as a proxy for financial statement fraud (Willits & Nicholls, 2014) We will use the number of AAERs issued to monitor the changes pre- and post- the Sarbaney Oaxley Act of 2002.

SEC Accounting and Audit Enforcement Releases (AAER) per Year



Quality of the Audit

98% of the United States audits are issued by the Big Four (Deloitte LLP, Ernst & Young, KPMG LLP, and PricewaterhouseCoopers LLP). The remaining 2% is audited by 372 firms, of which the Next Six with the most market share are BDO USA LLP, Crowne Horwath LLP, Grant Thorton LLP, MaloneBailey LLP, Marcum LLP, and RSM US LLP. To determine the quality of the auditors performance we inspected the data collected from the PCAOB.

Comparison of PCAOB Inspection Outcomes

Measure	Mean		
	Big Four firms	Next Six firms	Triennially inspected sample firms
Number of audits reviewed	1,091	496	266
Percentage of audits inspected	4%	11%	20%
Percentage of audits inspected with findings	36%	44%	35%
Percentage of audits inspected with "severe" findings	2%	1%	1%
Number of quality control releases during time period	8	3	2
Time period covered is 2010–2014 for Big Four and Next Six; 2009–2015 for triennially inspected firms			

Summary of Inspection Findings of the Big Four and Next Six

Number of issuers inspected with findings (percentage of issuers inspected with findings)					
	2010	2011	2012	2013	2014
Deloitte	26 (46%)	22 (42%)	13 (25%)	15 (28%)	11 (21%)
E&Y	13 (21%)	20 (36%)	25 (49%)	28 (50%)	20 (36%)
KPMG	12 (23%)	12 (23%)	17 (35%)	23 (48%)	28 (55%)
PwC	26 (39%)	26 (43%)	21 (40%)	19 (33%)	17 (30%)
Big Four average	19 (32%)	20 (36%)	19 (37%)	21 (40%)	19 (35%)
"Next Six" average	8 (41%)	8 (40%)	10 (49%)	9 (44%)	9 (51%)

Conclusion

From the results of quantification of fraud we can see there has been a drastic reduction in the amount of accounting related fraud that has occurred since 2002 -2003. With the exception of 2007 since the implementation of SOX the AAERs per year has reduced significantly in comparison with 2002 and prior. The quality of the audit as seen in exhibit 2 &3, show that over the years the average issues expected from the Big Four is about 20 issues from approximately 56 audits that are reviewed. This consistency shows that overall audit quality has remained consistent over the pass few years. With these result we can clearly see that SOX has continued to protect public interest by reducing the levels of fraud thus ensuring quality audits are being completed.

The bias that exist is we did not investigate whether the issues that arising in the audit review are consistent or if they varied across the Big Four and the Next Six.

References

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